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National Office TCR 17,888

Technical Coordination Report Submitted by Ms. Patricia  
Steele of [REDACTED] District Office - TCR #88-92

RECOMMENDATION: Issue a Revenue Ruling addressing discharge  
of indebtedness income for mortgage cancellations

Several newspaper articles were attached to this Technical Coordination Report setting forth the following circumstances: Mortgage revenue bonds were issued by the city of [REDACTED], to finance owner-occupied residences at a low interest rate of [REDACTED] percent during a period of much higher rates. After the bonds were issued, the interest rate for conventional mortgages dropped below [REDACTED] percent. Many of those who borrowed refinanced their loans, and sufficient cash accumulated in the bond retirement account to pay off the remaining bonds. In order to avoid earning a profit through receipt of additional mortgage payments so as to endanger the "tax-exempt" status of these bonds, the city cancelled the remaining mortgages.

We are not able to make any statement as to whether the revenue bonds are tax-exempt or not. Generally, early retirement of bonds will not cause the interest received on tax-exempt bonds to become taxable. However, when only a small percentage of bonds are used as intended, such tax-exempt status could be an issue.

You ask 1) whether a borrower having a mortgage debt cancelled (including accrued, but unpaid interest) realizes discharge of indebtedness income and 2), is the city of [REDACTED] required to issue Forms 1099 to report the cancellation of indebtedness income.

Section 61(a)(12) of the Internal Revenue Code expressly includes income from the discharge of indebtedness in the definition of gross income. This provision codifies the well-settled result reached by the Supreme Court in United States v. Kirby Lumber Co., 284 U.S. 1 (1931), that the cancellation or discharge of a debt by a creditor for less than the amount owed creates gross income to the debtor. Section 1.61-12(a) of the

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Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value.

Revenue Ruling 82-202, 1982-2 C.B. 35, holds that an individual taxpayer realizes discharge of indebtedness income under section 61(a)(12) of the Code upon the discounted prepayment to a lender of all or a portion of a mortgage indebtedness.

Section 108(a)(1) of the Code excludes discharged indebtedness from gross income for a discharge occurring (A) in a title 11 bankruptcy, (B) when the taxpayer is insolvent, or (C) if the indebtedness discharged is qualified farm indebtedness under section 108(g). Section 108(e)(2) provides that no income is realized from the discharge of indebtedness to the extent that payment of the indebtedness would have given rise to a deduction. For example, since due but unpaid interest on a loan incurred in a trade or business of a taxpayer would generally be deductible under section 163 of the Code if paid, section 108(e)(2) precludes the realization of income from the discharge of such interest indebtedness that would have been deductible if paid.

A taxpayer who excludes discharge of indebtedness income under section 108(a)(1) of the Code must reduce certain tax attributes and basis in property pursuant to section 108(b) in an amount not exceeding the amount of the excluded income. The affected tax attributes include net operating loss carryovers, general business credits, capital loss carryovers, and foreign tax credit carryovers. Special ordering rules and other limitations are provided in sections 108(b) and 1017. For example, section 108(b)(5) permits an election to reduce the basis in depreciable property under section 1017 before reducing tax attributes. Also, section 1017(b)(2) provides that, in the case of insolvency or title 11 bankruptcy, reductions in the taxpayer's total basis in property must be made only until the basis equals the taxpayer's aggregate liabilities remaining after the discharge. Interest not included in discharge of indebtedness income under section 108(e)(2) is not subject to the reductions in 108(b).

Although the TCR points out that mortgage cancellations are recently occurring more frequently in a number of areas in the country in addition to those in [REDACTED], we believe the tax results to the borrower of such a cancellation are very clear and the issue presented does not warrant a revenue ruling. The tax law applicable to the discharge of a mortgage indebtedness is already set forth in Rev. Rul. 82-202. We believe that taxpayers and practitioners should have no difficulty determining the consequences of an actual mortgage cancellation given that in

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Rev. Rul. 82-202 discharge of indebtedness results from a discounted prepayment of a mortgage. Also, in a recently published revenue ruling, Rev. Rul. 90-16, 1990-8 I.R.B. 5, this office clarified the bifurcated tax treatment in a mortgage foreclosure or deed in lieu of foreclosure situation, and further discussed the application of discharge of indebtedness. We do not believe that additional guidance in the mortgage discharge area is needed at this time.

It is the position of this office that Forms 1099 are not required to be filed in this situation. Section 6041 of the Code does not require such reporting because no "payment" is made when a debt is cancelled. Currently, only federal agencies are required to file Forms 1099 to report discharge of indebtedness, and that reporting is required not by title 26 but under directive of the Office of Management and Budget. We do not believe it is appropriate to publish in a revenue ruling the lack of a reporting requirement for non-government entities or to set forth requirements that are not found in title 26 for government entities.

We appreciate Ms. Steeles's interest and initiative in submitting her report concerning discharge of indebtedness, an area of tax law that is certainly receiving renewed attention. We hope that she will continue to provide us with her ideas. Copies of this memorandum are provided for Ms. Steele and other interested parties.

Sincerely,

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(Income Tax & Accounting)

By \_\_\_\_\_  
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